A STRATEGY FOR THE ENHANCEMENT OF THE TAX SYSTEM IN THE KYRGYZ REPUBLIC

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Abstract
The purpose of this paper is to provide analysis and specific recommendations for enhancing the tax system in ways that are consistent with the general objectives set out in the Comprehensive Development Framework of the Kyrgyz Republic. These recommendations are designed to fit within the guidelines set out in the Comprehensive Development Framework (CDF) – Sustainable Economic Growth and Development, Fiscal Policy. In addition it both supplements and comments on the proposals outlined in the government’s report on Tax Policy Concept in the Kyrgyz Republic.

The objectives of the reforms proposed in this paper are both to enhance the ability of the tax system to generate revenue, while creating a modern system of tax administration that is free of arbitrary decision making that impedes business activities by imposing high compliance costs.


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This report was prepared as part of a consultancy project on strategic planning in conjunction with the preparation of the government’s Comprehensive Development Framework (CDF) for the Kyrgyz Republic. This document deals primarily with the details of some of the tax issues that are associated with the implementation of the CDF.

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I. Overview

The purpose of this report is to provide analysis and specific recommendations for enhancing the tax system in ways that are consistent with the general objectives set out in the Comprehensive Development Framework of the Kyrgyz Republic. These recommendations are designed to fit within the guidelines set out in Section 4.3.3 of the CDF – Sustainable Economic Growth and Development, Fiscal Policy. It addition it both supplements and comments on the proposals outlined in the government’s report on Tax Policy Concept in the Kyrgyz Republic.

The objectives of the reforms proposed in this report are both to enhance the ability of the tax system to generate revenue, while creating a modern system of tax administration that is free of arbitrary decision making that impedes business activities by imposing high compliance costs.

The tax system must be simple, transparent and resistant to corruption. Tax instruments that are fertile breeding grounds for administrative corruption should be minimized or abandoned. Many of the important elements of a tax system that is consistent with a market-oriented economy were already put in place as early as 1996, however, over the past few years the multitude of tax amendments and misguided attempts to use of the tax system to create development incentives has eroded its ability to function in a sustainable manner.

II. Key Elements of Tax System for Kyrgyzstan

Some of the elements and issues related to the appropriate structure of the tax system are outlined below:

A. Value Added Tax

Discussion: At the present time the VAT is levied at a single rate of 20 percent. It is the most important source of revenue, being responsible for about 30 percent of total revenues. There is a fairly long list of items that are exempted, including such items as cars purchased for operation as a taxi, electricity, post office services, and baby food (however defined). The main defect of the VAT system is that refunds of excess tax credits are not been refunded to exporters. This issue will be dealt with in more detail later in the report.
This problem is partially due to the fact that customs collects significant amounts of VAT on imported inputs, but it is the domestic VAT administration that must give a credit for the taxes paid on the imported inputs. This causes the Customs to be able to easily meet their revenue targets, while the domestic VAT tax administration, bears the entire burden of the input tax credits, making it difficult for them to meet their revenue targets. An even major cause of the problem arises because the VAT refunded to exporters is considered to be an expenditure item from the perspective of the budget. Hence, as a way to control the deficit the VAT is collected on the inputs but no refunds are paid to exporters.

In many countries the refunds to exporters are paid out of the same account of customs in which the VAT receipts are deposited and it is the net amount each period that is turned over to the Treasury. In this way the VAT refunds would not be added to the total budgetary expenditures of the public sector; instead VAT revenues would simply be lower by the amount of the refunds.

**Recommendation**: Input tax credits should be allowed immediately, and refunds of excess credits should be given promptly to exporters. It is recommended that the VAT law be changed so that the refunds made to exporters are considered to be a reduction of the tax collected in each period by Customs and it is the net amount that is turned over to the Treasury.

**B. Excise taxes**

**Discussion**: Excise taxes amounted to about 15 percent of total government revenue in 2000. Of this amount approximately 60 percent comes from domestic excises and 40 percent of the revenue comes from the taxation of imported goods. The excises are applied to a range of 21 commodities, including oil products, alcoholic beverages, tobacco products, firearms and various miscellaneous items that are viewed to be luxuries including jewellery, rugs, coffee and cocoa. The present levels of excise tax collection are low as compared to a number of CIS countries and certainly many other developing countries. It is surprising that there appears to be no excise tax on automobiles and light vehicles. At the same time, vigilance needs to be exercised to see to what degree the revenues from the excise on any given commodity may become eroded by the increase in the specific commodity tax rates. This potential for erosion of the excise tax revenues is more likely to arise the greater is the ease in smuggling the goods across international borders.

**Recommendation**: A set of excise taxes should be levied on a smaller set of items as oil products, motor vehicles including cars and light vehicles, alcoholic beverages, cigarettes, and firearms. A more detailed examination of the revenue potential of taxing the other items on the current list should be undertaken, but with the exception of coffee they are unlikely to be significant. In general the rates of excise should be raised to be more in line with the rest of the CIS countries. Emphasis should be placed on the proper administration of a smaller set of excises that are likely to yield most of the potential revenues.
C. Import duties

Discussion:
At the present time there are three rates of import duties, 0, 10, 17.5, plus some specific duties on alcoholic beverages. Most goods enter the country at the zero rate of duty, and most of the rest of the goods are subject to a duty of 10 percent. Although it is a very positive factor that there is such a small number of rates of duty, the fact that so many items enter at a zero rate, provides a rich opportunity for customs officers to give importers a break by simply reclassifying the commodity that should be subject to a 10 duty into a category that is subject to a zero rate.

A number of countries in Latin America, after it was initiated by Chile, have implemented a uniform tariff policy with great success. There are three important advantages of having the same uniform rate of customs duties on everything imported. The first is that the country is able to raise a great deal of revenue with a low rate of tariff. Second, because there are no differentials, the scope for administrative discussion by the customs officials in the classification of goods is minimal. Third, a uniform rate of tariff on all inputs and outputs provides the same uniform level of protection to all commodities. Industrial protection is therefore not based on the judgment of the officials, which are usually simply bowing to special interests and not the fundamental economic advantages of the country.

Recommendation: Ideally customs tariffs should be set at an single rate between 5 and 10 percent depending on the revenue needs. The tariff should be on imported commodities and goods of all types, including both inputs and outputs. Differential rates that are desired for consumptive purposes eg. alcoholic beverages, automobiles, can be constructed by placing an additional uniform rate of excise tax on any particular good both if it is imported or domestically produced. If a single rate of import tariff was politically impossible to impose, then we would suggest that not more than two rates, 5 and 10 percent, be used but the economic and revenue advantages of a single rate are very important.

For exporters, a duty exemption system should be provided in order to relieve them from the burden of paying import duties on imported inputs that they will use to produce exports. A fuller discussion of this point will be made later.
d. **Land taxes**

**Discussion:** At the present time a general land tax exists in the Kyrgyz Republic. This is a very important step toward the administration a modern system of land taxation. A well-run land tax will provide a stable source of revenue for the maintenance of urban infrastructure and services. In addition, the receipts of the payments of the land tax in the rural areas will serve in practice as a substitute for land titles as a proof of ownership. Both of these factors argue strongly for the implementation of a modern land value tax.

At the same time it should be recognized that land taxes will generate a large amount of revenues relative to other tax systems, and the administration costs of a land tax are always high. Taiwan is the only developing country that we are aware of where land taxation has produced up to 10 percent of total tax revenues, yet it is always the highest cost per unit or revenue collected of all taxes in any country’s system.

**Recommendation:** The land tax should be streamlined and implemented with its first priority to tax urban land, and secondly rural land. Initiatives to tax also buildings and other structures should be resisted. That will only add complexity and a further avenue for corruption in the tax administration as the valuation of buildings is quite subjective. The land sites should be taxed on a area basis according to perhaps 4 or 5 different land value classifications. It is critical that a computer based land tax registration system be implemented and the land values be adjusted annually for the impact of the general rate of inflation. The reclassification of the properties in areas where the land use and the land values are changing at rates very different than the general rate of inflation, should be adjusted approximately every three years.

e. **Natural Resource Taxation**

**Discussion:** The development of any mineral property that involves foreign investment will require the agreement of a concessionaire contract, or some other form of agreement. The more that such agreements can follow a standard format with specified ranges for the values of the key parameters, the more transparent will be such negotiations and final contracts. Misunderstandings and the lack of transparency in such negotiations are often one of the sources of the bad impressions that foreign investors often have to face in some countries. Although some foreign mining companies are operating in a concession agreement with the state-owned company, at the present time no such models for a long term fiscal and concessionaire model exists that has been sanctioned by the government. Such models should be developed quickly as the potential for mining development is substantial. In addition, mining companies are more willing to go into countries that do not have adequate infrastructure than are most other investors. Relative to most mining areas in the world the infrastructure of the Kyrgyz Republic is quite good.
**Recommendation:** A structure of mineral taxes should be developed that relies primarily on a concession rental fee, ad valorem royalties, and an income tax on profits. A standard framework for the negotiation of mineral and oil concession agreements should be developed for use in the future.

### f. Income taxes

**Recommendation:**
We recommend that a flat rate of profits tax of about 15 percent be imposed. A possible exception to this rule might be natural resource producers and government regulated enterprises. These regulated sectors could be made subject to the normal low rate of income tax (e.g., 15%), plus a special tax of 10 to 15 percent on the profits of regulated enterprises and mineral producers. This tax would be similar to the one imposed in the late 1990’s by the labor government of the UK on the income of “previously privatized enterprises”. Significant amounts of economic rents are likely to exist in these enterprises at times when output prices are high.

The individual income tax should also be imposed at the same flat rate of 15 percent, or eliminated in order to make room for the social security charges that are levied on labor income.

Interest, dividend, rents, and royalty income should be taxed on a scheduler manner at flat rates that are final taxes.

**Discussion:**

The income tax is a major source of bureaucratic harassment, corruption, and a potent catalyst for the creation of the underground economy. At the present time the combined receipts of the income and profits taxes are relatively small, amounting to only twice the amount of the receipts from the road tax and emergency situation taxes that have a combined turnover rate of only 1.6 percent. It is likely to be many years before these income taxes will generate significant revenues. For example, Sri Lanka, Pakistan, and Nepal all have had income taxes for decades, yet they still yield less than 3 percent of GNP in revenues.

A special higher rate of profits tax is recommended for the regulated and natural resource sector enterprises. If the tax system does not capture the financial rents generated by the industrial protection and natural resource production then other interest groups likely will capture them.
At a basic rate of 15 percent or less most companies will not find it worthwhile to bribe officials or evade the profits taxes. The administrative challenge will be to set up a mechanism for the payment of the profits tax so that the companies are allowed to pay their profits tax without having to get the approval of officials.

g. Social Welfare taxes

Discussion: A major structural problem in the fiscal system of Kyrgyz Republic is the use of a payroll tax for financing the social fund. At the present time the total collections for the social fund is very significant, amounting to approximately 5 percent of GDP. The present combined employer and employee rate of tax is 37 percent on payroll costs. In addition there is the personal income tax with rates up to 30 percent. The combined effect of these two taxes on labor compensation is to cause the formal private sector labor market to be destroyed. The recommendation in the CDF is to put the entire burden of the tax on to the employee. This is not an improvement over the current system, if not worse, and is simply a recipe for the complete evasion of the tax.

The damage of this high tax burden extends beyond these two taxes. First, employers if they need to formally employ a person will understate the amount officially paid to the worker. The remainder of the person’s salary or wage is paid unofficially in cash. These unofficial wage payments cannot be deducted as a business expense for the purposes of the profits tax. In order to avoid paying the 30 percent profits tax on this overstated income, the enterprises will have to underreport the amount of sales by at least this amount. This is normally done by making cash sales for which no official records are kept. This underreporting of sales also results in a reduction in the payment of VAT, hence, eroding the base of the most important tax in the system - the Value Added Tax.

As more of the major state owned enterprises are privatized, it is certain that the revenues raised by the social security taxes will be eroded. Private sector employers and employees will not, and can not be forced, to pay combined marginal rates of income tax and social security taxes in low income countries that exceed 50 percent at levels of income equal to the average industrial wage. It is likely that the critical combined rate of tax is around 20 per cent in order to avoid this escape of employees from the formal labor market. To ignore this fact is simply to deny a reality that this country is experiencing. In order to prevent this erosion in revenues from shattering the deficit reduction program of the CDF, action needs to be taken now.

The payrolls of the existing workers should not be used as the tax base to finance the basic welfare component of the pension system. They are not responsible for the historical way in which such social security payments were levied. Some people have got wealthy through the transition process. They should also be
required to contribute to the alleviation of the extreme poverty that some older individuals now find themselves.

Given the level of income of the Kyrgyz Republic with a complete absence of a trustworthy financial system or capital market, it is unrealistic to plan for an actuarially sound pension system, or an experienced rated pay-as-you-go-system. The retired people of the Kyrgyz Republic need a well-managed social welfare system that is borne by all residents of the Kyrgyz Republic, not a disingenuous pension system that is financed only by those earning wages and salaries in the formal sector.

The first step toward providing the youth with a way to provide for their old age is to build a financial system where they can safely place their savings. Creating a public sector accounting system with promises to pay people a pension in 20 to 30 years time if they make contributions now, will be recognized as the fraud it is. Such a system will simply encourage many workers to stay in the underground or informal economy and minimize these forced contributions from which they expect to receive little or no benefit in the future.

**Recommendation:** There is a need to undertake a major structural reform of the way the pension (welfare) system is financed. A diversification of the burden is required. Various indirect taxes should be increased in order to take over some of this burden. The rich, including drug dealers, are unlikely to pay payroll taxes, or even income taxes, but they can be made to pay indirect taxes on what they consume.

An obvious candidate for taking over some of this burden is the excise tax system. At the present time they are rather modest in the Kyrgyz Republic as compared to other European or CIS countries.

Another part of the solution might be the one adopted by Uruguay. As a less developed country with a tradition of a very expensive social security system, the government of Uruguay eliminated the individual income tax and imposes only the social security taxes on all wages and salaries. The incomes of incorporated businesses run by an individual are subject to the same rate of tax as are corporations and partnerships.

Another part of the solution for the future is to put in place a legal framework for the development of a voluntary private pension system and the supervision of the managers of pension funds. In this way, financial institutions will have an incentive to demonstrate their soundness to attract long-term pension funds. This opportunity might also attract some established international financial institutions to enter the Kyrgyz market to manage such pension funds. Such a voluntary private pension system will also assist in creating the demand for capital market securities including bonds and stocks.
The contingent liability the government normally assumes when they impose a forced saving system for private funded pension systems is not present if the private pension investment is purely voluntary. If there is no demand for such voluntary private pensions, then this demonstrates the poor quality of the regulation and supervision of the financial system. Private voluntary pension systems have existed for centuries, so if the government regulators do their job to create a sound financial system, employers and employees will demand such pension services.

It is likely that the solution to the very serious problem of the funding of the social sector will be found in parts of all of the above recommendations. No single tax or payment system will have the strength to take over from the social welfare payments that are now being made by the state and semi-state enterprises.

h. **Turnover taxes**

**Discussion:** The recommendation has been made in the CDF and by others that the turnover taxes for the road tax and the emergency situation tax should be eliminated. The stated reason for their recommendation is the cascading nature of turnover taxes, and the fact that they do not allow for a credit to be given when goods are exported that contain the burden of these turnover taxes.

We do not dispute the economic or administrative characteristics of these taxes, but we question the conclusion of the quantitative level of economic or institutional damage that these taxes inflict in the context of the Kyrgyz Republic today. Although they are levied at almost insignificant rates they raise substantial revenues.

At the present time these two small turnover taxes raise about the same revenue as the individual income tax or the profits tax. However, they are not creating the level of havoc in terms of administrative complexity and corruption that either of these income taxes is generating. We fully agree that a turnover tax in excess of about 3 percent does create a problem of cascading and results in differential rates of effective tax. However, these rate differences are trivial as compared to the differences in the effective rates of profits tax across sectors.

The critical defect of the turnover tax is not its cascading behavior, but it is because it provides no mechanism to relieve exporters from the burden of this tax. On the other hand this is one of the very positive features of the VAT. However, if a turnover tax is levied at a modest rate of about 3 percent this impact is not so serious a problem. At the same time it helps recover some of the costs that the government incurs in providing the infrastructure and other services used by these export activities. In addition, it can be easily folded into the VAT at some time in the future by simply eliminating it and adjusting the rates of VAT accordingly.
**Recommendation:** If there is a serious need for tax revenue we suggest that all the existing turnover taxes for roads and emergency situations plus any of the other small nuisance taxes be turned into a single turnover tax at a rate of 3 percent. This tax would be levied in addition to the 20 percent value added tax. The turnover tax should be levied without exception on all sellers of goods and services. If it were decided for administrative or political purposes to have a patent system for the taxing of small taxpayers, then we would recommend that the turnover tax not be levied on those taxpayers who are subject to the patent system.

i. Patent taxation

b. **Discussion:** It has been recommended in the Tax Policy Concept paper that the patent system of taxation be expanded. It has even been suggested that once an individual small business had paid for a patent then no accounting records would be necessary! This seems to us to be taking the tax system in a dangerous direction. The advantage of the patent system is that once the tax is paid, the small entrepreneur has the right to hope that the tax administration will leave him/her alone to carry on with his/her business. It should be recognized at the outset that although there are many small informal enterprises, the total amount of revenue they will yield is very small. To force these many small enterprises to each pay a small amount of patent tax is more an important political statement of their willingness to support nation building, than it is a significant source of government revenue. Their major contribution to the economy is their role and ability to create jobs.

To suggest that in the Kyrgyz Republic, where there is a 98 per cent literacy rate, those small entrepreneurs should not keep a rudimentary cashbook is surely a misguided notion. If small business people are to have any chance of survival, they will have to keep some sort of financial records. The question is not whether the vast majority is capable of keeping a simple cashbook in order to pay a withholding tax, but rather is the level of official corruption and administrative harassment so high that it is advisable to have a way for a small business to have to negotiate with them only once a year?

The tax officials anywhere view a patent tax system as a gold mine for side payments and negotiations. If a patent system of taxation is used for anything other than the small informal sector firms and a few other special sectors, then the entire tax system will degenerate into a crude administrative assessment system. Such an experience has taken place over the past decade in Nepal where by 1998 over 96 percent of the business income tax assessments were made on a “best judgment” or patent basis. The result was that the business income tax system was hated by everyone and at the same time yielded less than 10 percent of total tax revenues. However, the system was so lucrative in corruption for the income tax
officials that other government officers were paying large sums of money to obtain a job transfer to the income tax department. Such a system should not be copied in the Kyrgyz Republic.

It should not be forgotten that the root causes of many of the current tax problems, is because of the excessive rates of income and social welfare taxation of labor income. In addition, the value added tax is not administered properly. Input tax credits are not being given to offset taxes due, and refunds are not being paid promptly after the exports have been made. The solution to these fundamental problems is not to introduce a broad system of patent taxation. Such a policy will only make matters worse.

**Recommendation:** It is our view that a system of patent taxation would be helpful at this time to provide a method for small firms in the informal sector, to be legitimized. Some other hard to tax groups, such as casinos and money exchanges, might also be included in such a patent system. However, the application of the patent system should be kept very narrow, without a lot of options for their application to an enterprise.

j. Special **Means Charges**

**Discussion:**
At the present time about 10% of total revenue is obtained by “Special Means Charges” that are not well defined or limited in scope. These items are the worst form of “tax farming” with revenue accruing to the state being the residual after the officials collecting these charges are paid off. The excess burden of this form of taxation cannot be justified, in a country that is attempting to build a modern tax system.

**Recommendation:**
The “special means” and “paid services” that are not specified clearly as user charges in the law for such things as education or health care, should be abolished.

III. **Critical Administrative and Tax Policy Issues for VAT**

**Value Added Taxation**

As a small country, the Kyrgyz Republic has little choice in its development strategy; it must engage in an expansion of international trade to raise productivity and increase incomes. To rely solely on its small domestic market for growth will surely lead to economic stagnation and an extended period of poverty. To emerge successfully from this difficult transition period, all efforts towards fostering economic development should be focused on improving the international competitiveness of the country’s producers.
This includes all its sectors from agriculture, to mining and to high technology activities. A clearly articulated and implemented policy that removes the fiscal and bureaucratic obstacles to the expansion of exports is urgently needed.

The foundation of a tax system that is designed with these objectives in mind is usually a well functioning value added tax system. At this time over 120 countries have introduced the VAT. Under the credit invoice method, all VAT registrants are obliged to collect and remit VAT on their taxable supplies. These registrants are allowed to recover the tax paid on their purchases. For each reporting period, registrants have to calculate the tax collected and remit to the tax authority the amount that is in excess of the taxes they paid during that period on their purchases of inputs. If the difference is negative, the registrants, if they are exporters, may claim the difference as a tax refund, or if not exporters, they can initially apply the credits to future tax liabilities and at some later point, if still in a credit position, can apply for a refund.

Additionally, since import taxes are normally payable at the time of importation, the VAT paid on imports is, in fact, included as part of the registrant’s input tax credit entitlement. In most countries, the proportion of VAT collected at Customs is generally very high. For example, the ratio is about 50 percent in Mexico, 40 percent in Indonesia, and more than 100 percent of the net revenue collected in the Czech Republic.

The central features of a value added tax system are the correct and immediate credit of the VAT taxes paid on inputs in the calculation of the current period’s tax liabilities, and the zero rating of exports along with the timely refund of the excess input tax credits in the case of exporters. In brief, the tax structure under the VAT system completely removes taxes from exported goods and thereby makes the exports more competitive in international markets. The system clearly encourages investment and fully supports exports. A VAT system cannot operate effectively in the absence of a well-functioning input tax credit and refund system.

At the present time the above key features of the VAT are not operating properly in the Kyrgyz Republic. The primary problem here in the Kyrgyz Republic as in many other countries is the length of time the government takes to refund the excess tax credits to the legitimate exporters. This is critical to exporters, since they must tie up substantial amounts of cash by paying input taxes. Exporters are often placed in the difficult financial position of waiting for refund of tax credits. Obviously, they would like to receive the refunds as quickly as possible to restore their cash flow.

**Potential Solutions**

In the case of suppliers to the domestic market, most countries specify that the VAT input tax credits are to be used immediately to offset taxes due on sales; or if there is an excess of credits, that they are to be carried forward to offset taxes due in the future. If the tax credits continue to be in excess of taxes owed for a specified period of time, then usually a provision is available to refund the excess tax credits in cash. For businesses selling to
the domestic market, the need for cash refunds of excess credits is a relatively infrequent event. The situation is very different in the case of major exporters. For example, in Uruguay, which exports very few manufactured items, the refunds given to exporters accounted for over 80 percent of all refunds. Here the excess credits will exist from before start-up and will accumulate. In order to safeguard the exporters from having a competitive disadvantage, they need a mechanism to turn the tax credits from input purchases into cash.

To complicate matters, people often use this refund system to carry out major fraud. For example, exporters may take undue advantage of their refund position and apply for excessive refunds on the basis of fake invoices for input purchases. This has been a serious problem in the administration of the VAT system in Thailand. Cases of such fraud have been reported in Uruguay, Mexico, and Indonesia. Another example of such fraud is when businesses export goods and receive a refund for input taxes, but then smuggle the goods back into the country to be sold in the domestic market without paying import duties and taxes. The administrative issues become even more complicated and fraud is made easier in the regional trading zones, such as the Common Market for Eastern and Southern Africa, or the countries of the CIS.

Most of the exporters would like to get their refunds quickly from the government in order to reduce their net cash outflows and thereby lower their cost of doing business. The government may also have a policy to help businesses by speeding up the payment of refunds. In such a situation, the tax administrators find themselves facing a dilemma. Will they process the refunds quickly and face the risk of approving fraudulent claims? Or will they audit every claim and, as a result, delay the payment of refunds to everyone?

In many developing countries, the result is the worst of all possible scenarios: because of the delays, the honest exporters have to bribe or “tip” the tax officials to get payment of their legitimate refunds. At the same time, such corruption makes it possible for others to bribe the tax administration officials to process fraudulent claims as well. Because of this potentially lucrative situation for auditors, a substantial number of them are assigned and/or are attracted to managing the export refund system. The end result is that the tax administrators make substantially more than they otherwise would receive as wages and salaries from the tax department, they pay more fraudulent refund claims, and the legitimate exporters get far less than they are entitled to. In our research to find ways to solve these problems, we have identified three “innovations” that show considerable promise and at least one that appears never to work.

The innovation that shows little or no promise is creating a new agency separated from the VAT and customs administrations, such as an export promotion agency, to administer refunds. Massive fraud is the usual result. The Philippines is currently experiencing such fraud; and Indonesia experienced similar difficulties in the early 1990s. These agencies never have the necessary information or technical skills to determine whether a claim is legitimate or fraudulent. Furthermore, such agencies do not have the safeguarding of the integrity of the fiscal system as their mandate; they exist solely to promote exports. In contrast, our studies revealed an innovation that has demonstrated some success in
speeding up the payment of refunds, but does not entirely alleviate the cash flow cost. With this innovation, the government requires taxpayers who apply for tax refunds to place bonds or a deposit equal to the amount of the refund (or some percentage of it) in special bank accounts until the government is comfortable with the claim. The claims, however, are paid immediately after the request is made. The tax authority is required to give final approval or deny the refund within a prescribed time period.

This scheme can apply to exporters as well as local firms requesting tax refunds. Firms that have developed a proven track record of honesty might be allowed to maintain a bank guarantee for a smaller percentage of the outstanding claims. This innovation places a tighter degree of control on excess input tax credits under the VAT system. Such a system was implemented in Taiwan during the early years of export expansion with great success. The government of Mexico has been implementing a similar but not so tightly structured scheme since 1999.

Another innovation with demonstrated success in speeding up the payment of refunds is to have tax refunds claims certified by local branches of international chartered accounting firms or bonded certified public accountants. This allows taxpayers to use the recognized accounting firms to verify the financial statement and a claim for input tax credits, thereby placing the responsibility of tax liability on both the taxpayers and accountants. This option should eliminate most of the fraudulent claims and, hence, reduce the government’s administrative costs. After Kenya introduced this system, the number of export tax credit refunds for VAT dropped by over 40 percent. Clearly, many firms had been submitting refund claims for VAT that did not stand up to the scrutiny of financial auditors. Such a system also frees foreign-owned firms from dealing with local tax officers, thereby reducing their compliance costs. Although the local accounting firms charge for their services, the service charge is well worth the cost, especially for large claims. In order not to place a financial burden on those requesting small refunds, a size threshold for the claims should be given to allow small claims to be made without the certification from an accounting firm.

The third innovation for speeding up payment of refunds is not to impose VAT on business purchases at the time of importation by specially approved exporters. By not charging VAT on imports, importers are not entitled to input tax credits when the imports are used in the production and distribution process. Hence, making imported inputs for export production VAT-exempt, or taxed at a lower rate at the time of importation, can substantially reduce the VAT input tax credits and claims for refunds by exporters. This approach has been implemented in Taiwan and Singapore. In Mexico, the government taxes import transactions at a lower rate when they are destined for the export processing zones along the Mexico-USA border. This has lowered the burden of excess tax credits. Nepal also exempts the imports of wool yarn from the VAT because it is entirely used by the manufacturers of carpets that are largely exported.

This option, however, may also create problems. If the importers cease operation or no longer file tax returns after bringing a consignment of goods into the country, then the government never collects taxes, resulting in a revenue loss. In other words, the
importers bring the goods into the country tax exempt and then attempt to sell the goods domestically without paying the VAT taxes. This can be significant in less developed countries where the informal sector of the economy is relatively large. It may also increase the administration costs for the government by breaking the invoice-tax-credit chain in the production and distribution process under the VAT. Depending on the country in question, this option may reduce the financial burden of export businesses due to the administrative inadequacy of the VAT refunds system.

To reduce the incentive for fraud and to increase the compliance in the tax withholding system for the income and social security tax systems, a country might wish to issue tax credit certificates to the exporting firms instead of cash payments to cover the VAT refunds. This system is being used in Uruguay with considerable success, although some fraud still has taken place. Virtually all firms will have withholding tax obligations that are substantial in the area of profits tax and social security taxes. It is likely that the VAT tax credits that need to be refunded to exporters will be less than those withholding obligations that these same firms should be paying. Hence, by integrating the administration of the refund system for VAT with the withholding tax system for business profits and social security taxes, both systems might be strengthened.

Nothing in tax administration is automatic. A system to audit the tax credit certificates to determine if they are legitimate is essential. However, at least the completely fraudulent claimant is likely to be restraint, because the tax credit certificate has value only if the firm also has employees and wage withholding obligations. These certificates should not be tradable (at least initially) between enterprises in order to avoid the fraudulent duplication of the certificates. There may be a few exceptional cases where the firm’s withholding obligations are less than its excess VAT input tax credits. Provisions might be necessary to issue cash refunds in these cases; however, the number of such cases will be very few as compared to the total that would exist if the tax credit certificate system were not employed.

These proposed institutional changes to the normal VAT administration can help to increase the effectiveness of the VAT systems, but they do not comprise a complete solution. The auditing function of the tax administration needs to be built and maintained. When this component of the tax administration is weak, substantial fraud is likely to follow.